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Cash or Credit: The Administration's Proposal To Make Companies With Junk Credit Ratings Put Extra Cash into Their Pension Plans

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There has been much press and discussion over the past few months about the poor funded status of corporation's U.S. defined benefit pension plans and the government insurer, the Pension Benefit Guaranty Corporation (''PBGC''). This month the Administration unveiled its proposal to change how defined benefit pension plans are funded.

The last significant pension legislation occurred in 1994 with the passage of the Retirement Protection Act (''RPA''). Back in the early 1990s, there was also much press about the poor funded status of corporations' U.S. defined benefit pension plans and the PBGC. To remedy the significant underfunding of pension plans, new funding laws were enacted. An integral part of the new law was an annual test of the health of pension plans. ''Sicker'' plans were required to receive additional funds while ''healthier'' plans had smaller funding obligations.

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Convinced that RPA did not solve the nation's pension crisis, the administration is seeking to amend these funding laws. Additionally, they are proposing a new, nonpension-related test. Specifically, in addition to annually measuring the health of a pension plan, the administration is suggesting measuring the health of the company sponsoring the pension plan (the ''plan sponsor''). Those companies that are rated unhealthy (or ''financially weak'') would be required to pay a higher insurance premium, put additional funds into their pension plans and face certain other limitations than otherwise ''healthy'' companies.

While the administration's proposal is conceptual and the details have not yet been presented, the notion of tying the health of plan sponsors to required pension funding is a novel one. For the first time, two otherwise identical pension plans will be treated differently solely due to the financial condition of the companies sponsoring the pension plans.

The administration's rationale for treating the pension plans of unhealthy companies more severely is to reflect its belief that the possibility of a plan termination is greater for these companies. Consequently, the administration wants to limit the amount of pension liabilities these companies can create and accelerate funding in these underfunded plans so that if they do terminate, PBGC's losses will be smaller.

Generally speaking, PBGC will terminate and assume trusteeship of an underfunded plan if the company is liquidating, the company receives bankruptcy court approval to terminate its plan, a company petitions PBGC to terminate the plan due to severe financial hardship, or PBGC believes it is necessary to prevent future

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losses.[1] When this occurs, PBGC assumes responsibility for the plan. It takes control of the plan's assets and liabilities and pays out benefits to retirees over the course of their lives in accordance with the plan's provisions, subject to a maximum benefit.[2] PBGC uses its funds to cover the deficit position in the plan.

Given PBGC's widening deficit, reported at $23.3 billion as of Sept. 30, 2004, the administration wants to mitigate future losses PBGC may incur.

Conceptually, it makes sense for an insurance company to manage potential losses and charge higher premiums for riskier clients. PBGC, as the sole insurer of private defined benefit plans, does not have the luxury of declining coverage for risky prospects. (By law, all defined benefit pension plans must carry insurance and by law PBGC is the only corporation permitted to offer insurance.)

The administration's proposal considers both the risk of a claim and the amount of the claim in computing the insurance premium. This represents a sound business practice and is an improvement over the existing methodology which only factored in a portion of the potential claim. For example, under the current system, two identical pension plans, one sponsored by a company with an AAA credit rating and one sponsored by a company in bankruptcy, pay the same premium to PBGC.

The administration is taking this concept to the operations of a plan, which differs with how insurance companies operate. The administration is proposing to levy more stringent ongoing funding requirements and limiting companies' ability to improve plan benefits if the debt of these companies is rated junk status. It may also prohibit funding of certain executive compensation benefit plans not subject to PBGC's authority.

Due to this new element of credit-worthiness being added into the pension formula and the significant cash requirements companies may face because of it, it is vital to understand how the administration is viewing credit ratings. In as much as financial concepts have not been incorporated into defined benefit plans before, a number of issues and questions come to mind.

1. How are ''healthy'' and ''financially weak'' defined?

''Healthy'' and ''financially weak'' designations will be determined based on senior unsecured debt ratings issued by the nationally recognized statistical rating organizations (i.e., Moody's Investors Service, Standard & Poor's, Fitch Ratings, and Dominion Bond Rating Service, together the ''Credit Rating Agencies''). For this proposal, ''healthy'' companies are those with at least one investment grade rating while ''financially weak'' companies are those with non-investment grade ratings as of the valuation date, usually the first day of the pension plan year.[3]

2. What if the plan sponsor doesn't have any unsecured debt ratings?

If the plan sponsor does not have any unsecured debt ratings, attention is turned to the issuer credit rating. This is a rating which reflects the Credit Rating Agencies' opinion of the plan sponsor's overall ability to meet its financial obligations as they become due. It does not reflect any particular debt instrument; rather, it is an overall reflection of a company's creditworthiness.

A random selection of Standard & Poor's corporate credit ratings reveal that the issuer credit rating is equal to or higher than the senior unsecured debt rating, so this appears a fine proxy for a senior unsecured debt rating.

In fact, one could argue that the issuer credit rating, and not the senior unsecured debt rating, is the more appropriate measurement of the risk PBGC faces. In rating a debt instrument, the Credit Rating Agencies consider the attributes specific to the instrument such as term, call features, creditworthiness of guarantors or other forms of credit enhancement, statutory and regulatory preferences, etc. These elements may not be applicable to pension plans. Rather, the risk to the PBGC is that a company will be unable to afford whatever obligations are due as well as its pension obligations.

3. Is it possible for a ''financially weak'' plan sponsor to be treated as a ''healthy'' plan sponsor anyway?

Yes.

Under ERISA, all entities under ''common control'' are responsible for funding the pension plan and the pension termination liability. All the entities under common control are referred to as a ''controlled group.''[4]

There are two general types of controlled groups: parent-subsidiary and brother-sister. A parent-subsidiary controlled group exists when a parent owns directly or indirectly at least 80 percent of a subsidiary. A brother-sister controlled group exists when the same five or fewer individual shareholders own 80 percent of two or more companies.

If a ''significant'' member of a plan sponsor's controlled group maintains a Credit Rating Agencies-issued investment grade rating on its senior unsecured debt, this credit rating can be substituted in lieu of the plan sponsor's debt rating, thereby creating a ''healthy'' plan sponsor.

This is appropriate. In as much as each member of the controlled group is jointly liable for the pension plan, the determination for risk should be based on the complete credit-rating landscape facing the PBGC and not just the credit profile of one entity.

At this early stage of the legislative process, the definition of a ''significant'' controlled group member has not been proffered. This definition may become a critical element for otherwise ''financially weak'' plan sponsors. It is not unusual for subsidiaries of complex corporations to carry their own debt ratings. Additionally, many companies utilize separate legal entities for financing purposes, which of course carry Credit Rating Agencies rated debt.

4. What happens if the Credit Rating Agencies don't issue credit ratings on the plan sponsor or any members of its controlled group?

The administration indicated it will draft regulations which will provide a blue print for companies to classify themselves as either ''healthy'' or ''financially weak''

[1] The criteria required for termination are found in ERISA §§ 4041 and 4042.

[2] The maximum pension benefit PBGC will pay is set annually and is based on the year in which the plan terminates. For plans terminating in 2005, the maximum annual benefit PBGC will pay to participants who retire at age 65 is $45,614. PBGC's guarantee covers basic pension benefits only. Additionally, PBGC does not pay lump sums in excess of $5,000.

[3] These designations apply to plan sponsors that maintain defined benefit plans covering at least 500 participants.

[4] The rules for determining a controlled group are found in ERISA § 4001(a)(14).

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based on certain financial measures. The one financial test included in the administration's proposal is a debt to equity measure. Specifically, the ratio proposed is:

$$\frac{\text{Long-Term Debt plus Underfunded Pension Liability}}{\text{Equity}}$$

If this ratio for the controlled group is 1.5 or greater, the plan sponsor is deemed to be ''financially weak.''

The pension liability is to be computed on an ''at-risk'' basis. (See Question 7.) The proposal is silent on whether debt would be based on book value or market value.

The equity value will be the fair market value for a privately held company or the market capitalization for a company with publicly traded stock.

No information has been provided with regards to how frequently a privately held company must perform a fair market valuation and whether the company itself may perform this analysis or retain an independent third party.

A more fundamental question is whether this approach is valid. Certainly some methodology needs to be developed to assess the heath of a company. Because the consequences of a ''financially weak'' plan sponsor are significant, with potentially millions more dollars required annually to fund a pension plan than an identical pension with a ''healthy'' plan sponsor, great care and thought need to be given to the methodology used.

In fact, Standard & Poor's cautions against simply using financial measures to arrive at a credit decision. In its Corporate Ratings Criteria 2005, Standard & Poor's states:

> ''Indeed, it is critical to understand that the ratings process is not limited to the examination of various financial measures. Proper assessment of debt protection levels requires a broader framework, involving a thorough review of business fundamentals, including judgments about the company's competitive position and evaluation of management and its strategies. . .At times, a rating decision may be influenced strongly by financial measures. At other times, business risk factors may dominate.''

Finally, rating agencies tend to have differing criteria for different sectors, recognizing the unique characteristics of each. For example, the financial measures of industrial and utility companies are not expected to be similar to those of financial companies. It will remain to be seen whether the Administration's regulations take into consideration such nuances.

5. What happens if ratings decline from ''healthy'' to ''financially weak'' during the year?

If, during a plan year, a plan sponsor falls from the ''healthy'' category to the ''weak'' category, the change in required funding targets is phased in ratably over a 5-year period as of the start of the next plan year.[5]

This appears fair as it provides a company with advance notice of increased funding requirements and allows an extended period of time to phase in the change.

However, empirical evidence demonstrates that companies which decline from investment grade to non-investment grade (referred to as ''fallen angels'') are more likely to default in the short term than companies who have been non-investment (also referred to as ''speculative'') grade for long periods of time. According to the Standard & Poor's research study *Fallen Angels: To Rise No More?*, published Jan. 30, 2003,

> The mortality analysis provides convincing evidence in support of the theory that fallen angels are more likely to default in the short term than are other issuers that were originally assigned a speculative rating. However, the mortality analysis also shows that, in the long run, fallen angels may actually have the same default rate as other similarly rated companies.

This observation implies that fallen angels pose a significant threat to their pension plans during the time period when the proposed increased funding is being phased-in.

6. What happens if ratings improve from ''financially weak'' to ''healthy'' during the year?

If, during a plan year, a plan sponsor improves from the ''financially weak'' category to the ''health'' category, the lower funding targets (i.e., computing liabilities on an ''ongoing'' basis) are not employed until the next plan year. There is no relief provided in the current plan year.

The proposal calls for the pension liabilities of ''financially weak'' companies to be calculated differently so as to have larger liabilities than ''healthy'' companies. This creates larger underfunding and consequently larger required pension payments over up to seven years. (Questions 7 & 8 describe the proposed liability and minimum funding calculations.)

It seems harsh to penalize a company because it did not receive an investment grade rating on an exact date in the plan year. A fairer approach might be to allow a plan sponsor to re-compute the minimum funding obligations as if the plan was ''healthy'' as of the start of the plan year.

7. How will the pension liabilities of a ''financially weak'' plan sponsor be calculated compared to those of a ''healthy'' plan sponsor?

There are different ways to measure pension plan liabilities, depending on the assumptions and interest rated used in the calculation. For all plans, the administration is proposing a new interest rate structure for present valuing pension liabilities—a corporate bond yield curve, which would be issued monthly by the Secretary of the Treasury along with a mandated mortality table.[6] In addition, the administration is proposing certain required assumptions for pension liabilities of ''financially weak'' plan sponsors.

''Healthy'' plan sponsors will value their liabilities on an ''ongoing'' basis, which is generally how liabilities are measured today, with the exception of the newly mandated yield curve feature.

''Financially weak'' plan sponsors will value their liabilities on an ''at-risk'' basis. This is similar to the ''ongoing'' basis with three changes:

- the assumed retirement age assumptions should be accelerated to the early retirement age permitted under the plan,
- if lump sum payments are offered in the plan, the benefits should be valued assuming they are received as lump sum payments (or whatever form results in the largest liability), and

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[5] This transition approach also applies to plan sponsors who became ''financially weak'' within the past five years prior to enactment of this legislation.

[6] The administration is proposing a two-year transition from the existing ''current liability'' interest rate environment to the yield curve methodology.

■ an expense "loading factor" must be added to the liability to reflect the administrative cost of purchasing a group annuity if the plan were to terminate; this loading factor is set at $700 per participant plus 4 percent of the "at-risk" liability (before the loading factor),[7]

provided however that the"at-risk" liability cannot be less than the "ongoing" liability.

8. How will required annual minimum funding be calculated?

The proposed funding calculation would include two components: normal cost (generally the cost of benefits earned during the year) and required amortization payments, described below.

At the beginning of the 2006 plan year, the market value of the plan's assets is subtracted from the liabilities (either "ongoing" or "at-risk" depending on whether the plan sponsor is "healthy" or "financially weak") to derive the amount of underfunding. This underfunded amount is required to be amortized in seven equal annual payments beginning in 2006.

For the subsequent plan year, the sum of the market value of the plan's assets plus the present value of the future amortization payments is compared to the plan's liabilities (computed on an "ongoing" or "at risk" basis as applicable depending on the plan sponsor's health in that year). If this is an underfunded amount, then a new amortization base is established equal to this underfunding which will then be amortized in seven equal payments. (In our example, minimum funding in 2007 would be the sum of normal cost plus "year 2" of 2006's amortization payment plus "year 1" of 2007's amortization payment.) If the sum of the market value of plan assets and present value of future amortization payments exceeds the liabilities, no new amortization base is established; rather, the required amortization payment would equal the previous year's amortization payment (except to the extent that an amortization base has run off).

The process of comparing the plan's market value of assets plus the present value of all the future amortization payments to the "ongoing" or "at-risk" liabilities and arriving at an underfunded amount which would be required to be amortized in seven year installments is repeated each year until the market value of plan assets is equal to or greater than the plan's liabilities. At such time, the amortization payments cease and all amortization bases are eliminated.

Since "financially weak" companies would be required to fund to the larger "at-risk" liability, all other things being equal, the non-investment grade company will face greater immediate cash obligations. No transition period is proposed for valuing the "at-risk" liability for plan sponsors that have been consistently rated below investment grade for the past five years.

9. Limitations on benefit improvements.

The administration is proposing to limit benefit improvements if the ratio of the plan's assets to liabilities (either "ongoing" or "at-risk") is 80 percent or less, unless the plan sponsor contributes the increase in the liability (again on an "ongoing" or "at-risk" basis) attributable to the plan amendment. If this ratio is greater than 80 percent and less than 100 percent, benefit improvements would be permitted provided the improvement does not cause the ratio to drop below 80 percent. If the benefit increase were to cause the ratio to drop below 80 percent, then it would only be allowed if the plan sponsor contributed funds to maintain the 80 percent ratio.

10. Limitations on lump sum payments.

Many plans allow participants to choose the form of their pension payment. Participants can elect to receive monthly payments over the course of their lives or take a one-time upfront "lump-sum" payment. The administration's proposal is limiting the lump-sum (or other accelerated benefit forms) option for all plans, albeit at a more stringent threshold for "financially weak" companies.

For "healthy" plan sponsors, lump sums would be prohibited if the ratio of the plan's assets to "on-going" liabilities is 60 percent or less. For "financially weak" plan sponsors, this ratio jumps to 80 percent and is measured using the larger "at-risk" liabilities.

This prohibition remains in effect until the next plan year in which the ratio targets are achieved and requires a plan amendment "restarting" the lump-sum (or other accelerated benefit form) option. This amendment is subject to the limitations and cash requirements discussed in Question 9 above. For "financially weak" plan sponsors, the "at-risk" liability must be calculated assuming participants choose lump sums.

11. Stopping the defined benefit plan from operating normally.

The administration is proposing a special limitation on "financially weak" plan sponsors that maintain plans with a ratio of plan assets to "at risk" liabilities of 60 percent or less. In these situations, the rules require the plan sponsor to "freeze" the plan. Such an action ceases all further benefit accruals. In other words, no new benefits are earned. Participants have what they have on the date of the freeze and do not get more.

This freeze continues until a future plan year in which the targeted 60 percent is exceeded or the plan sponsor is no longer "financially weak." At that time, the plan can be "unfrozen" but only via a plan amendment. This plan amendment concept is noteworthy due to the financial consequences it may have on plan participants.

When a plan terminates and PBGC becomes plan trustee, PBGC computes the amount of benefit each participant should receive subject to the existing maximum guaranteed limit. In arriving at this amount, PBGC reviews plan amendments because PBGC phases-in plan amendment benefit increases into the guarantee equation. Plan amendments are guaranteed by PBGC over a five-year period ratably. So that if an underfunded plan terminates two years after a plan amendment is enacted increasing benefits, PBGC will guarantee just 40 percent of this increase.

Further, the plan amendment "restarting" the plan is subject to the limitations discussed in Question 9 above. This requires a plan sponsor to fund the benefit increase at the time it is enacted.

[7] The administration's proposal did not explain the derivation of the $700 per participant charge or the 4 percent liability bump-up. These figures differ from current rules. For plans with at least $200,000 in liabilities, PBGC regulations today require plan administrators to incorporate a loading factor of $10,000 plus $200 per participant plus a percentage bump-up in liability when computing the liabilities of terminated plans. While today's bump-up is a function of PBGC's interest rate used to value liabilities, it is significantly less than the proposal for plans with substantial liabilities.

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This is a dramatic aspect of the administration's proposal. In balancing the need to maintain a healthy pension insurance system with the ability of a company to offer employee benefits and the importance of providing retirement income for employees, the administration is favoring PBGC.

12. Limitations on executive compensation benefits.

The administration is proposing limitations on funding nonqualified executive compensation benefits for certain ''financially weak'' plan sponsors and for companies that terminate underfunded plans. This limitation applies to all ''top executives''[8] in the plan sponsor's controlled group, including former employees who were top executives at the time their employment terminated.

Specially, for ''financially weak'' plan sponsors who maintain a plan with a ratio of plan assets to ''at-risk'' liabilities of 60 percent or less, the proposal prohibits the funding of nonqualified executive compensation benefits such as rabbi trusts, insurance policies, or other funding vehicles.

For companies who sponsor underfunded pension plans which terminate, the proposal prohibits the funding of nonqualified executive compensation six months before and after the pension plan termination.

It is not clear if this limitation applies to new nonqualified executive compensation benefits created after this legislation is enacted or to existing programs as well.

The proposed law provides the pension plan with rights of action to enforce this measure. The right allows the plan to recoup the amount of compensation funded along with attorney's fees. The plan sponsor must inform the pension plan fiduciaries of its funded deferred compensation arrangements in these situations. The fiduciaries must be provided access to the company's books and would be legally obligated to take reasonable steps to pursue recoupment.

In as much as PBGC becomes trustee, and de facto plan fiduciary, shortly after plan termination, it is assumed that the right to recover funds from nonqualified plans would shift to PBGC, including right to access company books and records.

13. Premiums.

The administration is proposing changes to the annual premium calculation. By all accounts, the existing premium methodology is nonsensical in that it does not reflect the size of a potential claim or the likelihood a claim may be presented.

The structure will remain intact. That is, the premium amount will be the sum of two components: a flat-rate fee per participant and a variable fee for underfunding, if any. The proposal calls for an increase in the flat-rate fee from $19 per head to $30 per head, subject to future indexing to the Social Security Administration's Average Wage Index. The portion attributable to underfunding is a yet unknown percentage of plan underfunding. Underfunding will be computed on either the ''ongoing'' or ''at-risk'' liability basis, as applicable.

Clearly, the administration's proposal, if enacted, will cause non-investment grade companies to pay higher premiums, face more stringent funding schedules, encounter greater restrictions on how they operate their pension plans, and possibly cease funding certain executive compensation arrangements. These new limitations will directly impact plan participants. The two obvious questions are:

(1) Is the administration accurately measuring this perceived risk?

(2) Is this a fair and balanced approach?

Certainly, splitting the pension universe into investment grade and non-investment grade companies is easy to understand, classify, and based on established financial measures of risk. But is the administration painting all non-investment grade companies with a broad brush? Not all non-investment grade companies pose the same level of risk. Just because a company is rated non-investment grade does not necessary imply it will need to terminate its pension plan or otherwise not meet its financial obligations. As discussed above, fallen angels pose a greater risk than those companies originally rated non-investment grade. Even companies originally rated speculative face differing levels of risk. A company rated BB+ should pose less concern than one rated CCC+.

There is also a perceived disadvantage in company size in achieving a rating. Many financial executives bemoan the rating agencies' small size bias. That is, there is a belief among many financial individuals that, all things being equal, a large company will receive the investment grade rating while a smaller one will not. In its Corporate Ratings Criteria 2005 handbook, Standard & Poor's categorically states that ''Standard & Poor's has no minimum size criterion for any given rating level.'' But it immediately adds ''However, size turns out to be significantly correlated to ratings.'' If there is, in effect, a glass ceiling with respect to investment grade ratings for small companies, is it appropriate for the administration to subject these otherwise healthy companies to the more onerous restrictions?

It is also interesting to note the administration's reliance on the Credit Rating Agencies while oversight committees in the U.S. House of Representatives and Senate, as well as the U.S. Securities and Exchange Commission, are currently exploring concerns and potential defects with the Credit Rating Agencies system.

Finally, if enacted, is this a good public policy? There are those who will say yes. Risky companies drag down an otherwise viable and legitimate system and should face harsher actions. All measurement systems are imperfect and the one proposed is defendable and intuitive.

Others might focus on the potential self-fulfilling prophecy of the legislation. By requiring companies that might already be stressed to face additional non-negotiable fixed charges, this could lead to increased business failures and pension plan terminations, thereby exacerbating the weaknesses in the existing pension insurance system. After all, companies, particularly non-investment grade ones, can only generate and borrow so much cash flow. Additional cash that would be required in this new legislation are monies that might be otherwise diverted from R&D, new job generation, capital expenditures, existing debt repayments, etc. And the potential treatment of the pension plans—limiting sum lumps and freezing benefits—as well as the potential non-funding of executive compensation, may cause employees to choose to work for an investment grade company over a non-investment grade one.

[8] A definition of a ''top executive'' is not provided in the administration's proposal.